

Central Intelligence Agency



Washington, D.C. 20505

## DIRECTORATE OF INTELLIGENCE

17 May 1984

## International Monetary Reform: Summit Country Perspectives

Summary

Reform of the international monetary system should not be a divisive issue at the Summit, but US economic policies which affect the operation of the system will be criticized. No major reform initiatives are planned by the other Summit participants; specific topics that will probably be raised at the Summit include:

- o **Exchange Rate Uncertainty and Economic Convergence.** Most Summit countries argue that the US deficit is affecting interest rates and is a source of uncertainty--along with the US trade deficit--in the exchange markets. Strong support for a general statement in the communique about improving economic convergence to help stabilize exchange rates can be expected. Also, France will likely seek to extend the Williamsburg consensus on foreign exchange market intervention by central banks to reflect its more activist approach. [redacted]
- o **SDR Allocation.** France will push hard for a consensus supporting a new SDR allocation. Italy also supports a new allocation and Canada has publicly called for a modest increase of SDRs. Japan and West Germany, which have opposed the allocation up until now, may opt for the Canadian proposal as a compromise. [redacted]

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This memorandum was prepared by [redacted] the Office of European Analysis. It was coordinated within the Directorate of Intelligence, with the Directorate of Operations, and reviewed by the Department of the Treasury. Questions and comments may be addressed to [redacted] Chief, European Issues Division, [redacted]

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- o **LDC Debt Situation.** France or Canada may want to include a statement in the communique that the summit countries support a "medium-term solution" to LDC debt problems. French proposals call for increased cooperation between the IMF and World Bank, boosting of World Bank lending and softening of loan terms, and making the World Bank "aid coordinator" for multilateral and bilateral aid. While most summit countries, including West Germany, believe that supply should be emphasized more in LDC adjustment programs and demand restraint less, they are unlikely to support major institutional reforms or a statement in the communique that might lock them into a specific proposal. [redacted]

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At the Summit, the biggest problem for the United States in the international monetary area may be that opposing a new SDR allocation, combined with the present size of the US budget deficit, may make the United States appear insensitive to international monetary difficulties. Increasingly the other summit countries view an SDR allocation as a necessary gesture to the LDCs. While they realize that reducing the US budget deficit will take years to accomplish, the other summit countries believe some positive steps in this direction must be taken soon if exchange rate stability and economic convergence are to be achieved. [redacted]

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International monetary reform is certain to remain an important issue at future summits, although we do not expect other summit countries -- with the exception of France -- to suggest fundamental reforms anytime soon. Paris, in addition to its institutional proposals, will continue to advocate a tripolar exchange rate system among the dollar, yen, and ECU, but support from the other major West European countries probably will remain weak. Most of the other summit countries agree that the present international monetary system has a high degree of flexibility built into it and, as a result, they are likely to propose only measures intended to fine-tune the system. Moreover, most would probably like LDCs to undertake additional steps

on their own that would ease debt financing problems. For example, LDCs have yet to begin implementing domestic measures that would encourage foreign direct investment and lessen the need for debt financing. The issues surrounding international liquidity--its determination, currency denomination, and distribution--will probably be the most contentious to resolve; SDR allocations are internationally negotiated, and significant legal barriers remain to the internationalization of currencies other than the dollar. [REDACTED]

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## Introduction

Reform of the international monetary system has been under almost constant review since December 1971, when the fixed exchange rate system agreed to at Bretton Woods in 1944 began to crumble. In March 1973, after 15 months of experimentation with the Smithsonian central rate system keyed to the dollar and after several crises in the exchange markets, a de facto flexible exchange rate system emerged. Sharp fluctuations in exchange rates followed and prompted the major governments at the first economic summit in 1975 at Rambouillet to address the problem of international monetary reform. A consensus developed that stability in the exchange market can stem only from the harmonization of economic policies and performance; agreement that some coordination of exchange market intervention to "counter disorderly market conditions or erratic fluctuations in exchange rates" was also reached. [REDACTED]

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The International Monetary Fund (IMF) built on the Rambouillet consensus to develop a broad system of bilateral surveillance over member exchange rates and economic policies. In the wake of the two major oil price increases and subsequent world economic recessions, however, convergence of economic policies proved difficult. As a result, problems in exchange markets persisted. The summit countries again took up monetary reform issues at the Versailles Summit in 1982 and reaffirmed the Rambouillet consensus. An annex to the Versailles communique

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provided for strengthening IMF bilateral surveillance of member countries by incorporating multilateral surveillance of the G-5, or countries whose currencies make up the special drawing right (SDR): the United States, Japan, West Germany, France, and the United Kingdom. The first multilateral surveillance review was held in Toronto in September 1982; they are now held twice a year. [ ]

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Discussions of international monetary reform have continued among the finance ministers of the ten industrial countries called the Group of Ten, or G-10. Formed in Paris in 1962, the ad hoc ministerial meetings have since dealt with problems relating to the functioning and structure of the system. [ ]

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Many of the G-10 countries now apparently want to consider international monetary problems in a broader context by going beyond the discussion of measures aimed at limiting exchange rate movements. The Williamsburg Summit produced a consensus to study the range of issues and to consider at some point convening an international conference. This approach was prompted by the problems that have plagued the monetary system over the last couple of years. [ ]

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- o Divergent economic policies among the major countries have contributed to exchange rate fluctuations, precipitating harsh criticism among the major countries about the management of their respective economies.

- o Capital flows have complicated efforts to stabilize exchange rates as investors and speculators adjusted their portfolios based on changes in expectations about economic performance in the major countries.
- o Dependence on the dollar as the primary international reserve asset and major denominator of international trade and debt has resulted in higher real costs for net debtor countries during the last few years when the dollar strengthened. Significant barriers remain in West European countries and Japan to the internationalization of their respective currencies, and SDRs are determined by a political process, not directly by economic factors.
- o The LDC and East European debt crises have highlighted the individual limitations of, and lack of coordination among, international institutions. Resources have been strained at times and the demand restraint programs of the IMF have not always fully taken into account the impact on World Bank development programs.
- o Protectionism has negatively affected the level of world trade and restricted the ability of the LDCs to earn funds to service their debt.

The G-10 finance ministers now are studying three international monetary problem areas: the functioning of the exchange rate system, the level of international liquidity, and

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the role of international institutions, particularly the IMF and the World Bank Group. Thus far, work has focused on exchange rates and the related area of the Fund's role in the surveillance of the G-5 economies. Discussions have also addressed how the Fund's surveillance role can be strengthened as well as how to make it more symmetrical by requiring policy adjustments not only of the net users of Fund resources, mostly the LDCs, but also the net contributors. [redacted]

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Some G-10 countries also are urging that more steps be taken for the development of a medium-term approach to the debt crisis, a difficult exercise because of the large number of issues involved and the different country positions involved. Moreover, LDCs have a large stake in the outcome and will advance their own initiatives. [redacted]

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#### Views on Reform\*

##### Exchange Rate System: Near Consensus

All the summit countries except France have extolled the virtues of flexible exchange rates, agreeing that a flexible rate system was the only viable alternative over the past economically troubled decade. While the French agree that exchange rates should respond to underlying economic trends, they have argued publicly and in G-10 meetings that central banks should intervene

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\* The Appendix provides synopses of summit country positions on international monetary reform.

regularly to ensure that exchange rates move appropriately. The French position stems from their belief that international capital flows--which can exert strong influence on exchange rates--do not always reflect the underlying economic trends and lead to perverse exchange rate movements. Japan and West Germany, in contrast, maintain that intervention should be utilized only when markets are disorderly. They have concluded in studies presented to the G-10 that capital movements usually precede changes in economic fundamentals. Capital movements, they argue, are based on investors' expectations about future government policies and the performance of the respective economies and cannot be systematically countered by official intervention.

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All the summit countries, including France, believe the best way to improve the exchange rate system in the short run is to coordinate monetary and fiscal policies through the forum provided by the multilateral surveillance process. Opinions vary considerably among the G-5 countries concerning the effectiveness of multilateral surveillance, but all agree that the forum is useful because it provides a regular and focused opportunity for the G-5 to exchange views on economic policies and performance. The managing director of the Fund attends the meetings and provides background and data supplied by the IMF staff, but does not make any formal IMF recommendations. Members are limited to moral suasion when proposing changes to economies other than

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their own. Both Japan and West Germany see the Fund's role in this exercise as an educator; Canada and the UK have expressed similar views, through Ottawa believes some improvements should be made. France and Italy are not satisfied with the current surveillance process and would like it strengthened and broadened. France wants the process to include all EMS countries and generally to have the Fund play a more direct role in the policy review sessions. Italy and Canada, not members of the G-5, want surveillance expanded to the G-10. Rome would like stronger IMF participation and would prefer to have the meetings held prior to the formulation of domestic policy. In addition, Rome has suggested that the results of the surveillance meetings be made public. [REDACTED]

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For the medium term, the French are continuing to push a proposal first launched by President Giscard in the 1970s calling for a tripolar managed exchange rate system among the US dollar, the Japanese yen, and the European Currency Unit (ECU). All other countries would either peg their currencies to one of these three or to the SDR. [REDACTED]

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#### International Liquidity: Fundamental Problems

The summit countries are divided over the immediate question of a new SDR allocation by the IMF. The longer-term issues of reserve creation and composition are even more contentious. France, Italy, and Canada have gone on public record supporting a new allocation of SDRs, though none has given support to the LDC

proposal of a \$45-billion equivalent over the next three years. The SDR share of international reserves has fallen since the 1970s and these countries generally favor restoring that share. Moreover, both France and Canada have supported LDC calls to increase the flow of resources to the Third World. French Finance Minister Jacques Delors has frequently said that a new allocation is needed, though he has not specified any amount. Canadian Finance Minister Marc Lalonde has suggested a range of \$8 and \$14 billion over the next two years, an amount that would raise the SDR share of world reserves to that of the 1970s. Although Japan, West Germany, and the UK have opposed a new allocation at this time, both Japan and West Germany at the April Interim Committee meeting gave some indication they might accept a compromise figure, according to press reports. Both probably believe that some gesture is needed and would have little inflationary impact. [REDACTED]

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The longer-term problems of determining international liquidity needs and the structure of international reserves are more difficult than the SDR issue. Some initial work by the G-10 countries and the Bank for International Settlements (BIS) has been done in this area, but generally the summit countries do not yet have clear positions. [REDACTED]

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Institutional Reform: Myriad of Views

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The G-10 countries generally agree that the international institutions need strengthening, but national interests and differing views on how to best foster LDC development will work against any speedy agreement on specific changes. Moreover, G-10 work on institutional reform at some point will have to involve the LDCs, further widening the national interests involved.

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Bilateral Surveillance. The other summit participants all give strong support to the role of the IMF in bilateral surveillance of economies that are net users of Fund resources--mostly the LDCs. The summit countries have generally supported traditional IMF recommendations aimed at the short-term improvement of key economic variables in LDCs: the money supply, the government deficit, international reserves, and the current account in the balance-of-payments. The classic IMF program, however, has been questioned by several major countries--West Germany, France, and Canada--because of its strong reliance on demand restraint. The G-10 will reevaluate this approach as it addresses the problem of medium-term solutions to the debt crisis and complementarity of international institutions.

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Greater Complementarity. Agreement is building among some G-10 countries--notably West Germany, France, and Canada--that the demand restraint measures of the IMF have to be emphasized less and the longer-term, supply-oriented, World Bank lending programs emphasized more. The current 15-month adjustment period for IMF standby programs is believed too short for overextended LDCs, and the restraint demanded is harming the long-term growth prospects of the countries. Some informally mentioned steps to improve coordination among the two institutions include:

- o Joint staff country visits.
- o Joint country assessments, taking into consideration each institution's program.
- o Joint board meetings.

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The potential effect of joint programs under present Fund and World Bank operations would be an expansion of IMF conditionality to World Bank loans, a prospect Japan finds interesting but which LDCs would strongly resist. Already there is some conditionality attached to a small proportion of World Bank lending; structural adjustment loans carry a requirement that the recipient country must be in compliance with an IMF program. France, along with its proposal to extend World Bank lending up to 20 years and soften loan rates, has proposed a 5 to 7 year adjustment period for countries undertaking and adhering to an IMF program.

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A number of summit countries believe greater complementarity will also have to involve the GATT and other trade organizations, possibly the International Trade Organization and the UNCTAD Common Fund for LDC commodity support. The need to increase the linkage between trade and financial problems has been widely acknowledged and is currently under study by the OECD. Canada favors a new trade round by "mid-decade," and all major countries acknowledge that there are serious trade problems. Preparations for a trade round would be lengthy, however, because extensive prior consultations would be required to establish a consensus. Ironically perhaps, LDCs are not in favor of a trade round at this time and are seeking the resolution of current trade issues, which they believe are in violation of GATT rules, and those left over from the 1982 GATT Ministerial. [REDACTED]

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Institutional Resources. Among the summit countries, only France and Canada support a general increase in resources of the World Bank. Motivated in part by its large number of former colonies, Paris has traditionally favored increasing multilateral development aid and lending. In addition to softening the terms of World Bank loans, Paris would like to increase Bank lending by raising the current 1:1 capital-to-lending ratio. It also is advocating increasing the Bank's sectoral loan share of total lending above the current 10-percent ceiling. The French envision the World Bank as world "aid coordinator" for multilateral as well as bilateral aid. While generally

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supportive of French proposals, Canada has yet to formulate a clear position. Other summit countries do not at this time support the French proposals. [ ]

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Outlook for the Summit

International monetary reform is not expected by any of the other six countries to be a divisive issue at the summit, although a number of sensitive issues, such as the impact of US economic policy on the international monetary system, will be raised in the discussions. No country, including France, is expected to make a major proposal concerning international monetary reform. In general, we expect the other governments to strike a positive chord on the work in progress, particularly the studies undertaken by the individual G-10 countries, as well as by the IMF, BIS, and OECD. Some countries--notably France, Italy, and Canada--will point out that despite the overall improved outlook, progress on reform has been moving too slowly. They may propose that the communique include a statement calling for continuing the momentum developed at Williamsburg. Specifically, we believe the following issues will be raised: [ ]

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- o Foreign Exchange Market Intervention. France can be expected to suggest extending the Williamsburg consensus regarding the need to smooth exchange rate changes through coordinated intervention. There is still a considerable uncertainty in the exchange markets and

observers still believe that the US trade deficit may eventually trigger a rapid change in rates. Although Paris is virtually alone in its desire for active central bank intervention in the markets, other West European countries may passively accept a French initiative so long as the wording remains vague. [ ]

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- o Multilateral Surveillance. Most summit countries are unhappy over the lack of results of multilateral surveillance in achieving economic convergence, and a few will seek to strengthen its structural process. France and Italy in particular, and possibly Canada, can be expected to cite the inadequate structure of the system and to call for firmer and more formal procedures. Probably all the other participants will once again criticize US fiscal policy. US efforts to reduce the deficit may be cited as a positive development, but recent increases in US interest rates will be condemned for hurting the Western recovery and making the plight of LDCs much worse. The summit countries will almost certainly want a general statement in the communique to the effect that the Big-7 will seek to pursue sound, outward-looking internationally compatible policies. [ ]

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- o SDR Allocation. France will push ardently for a consensus supporting a new allocation of SDRs. Italy

and Canada will support France, and Japan and West Germany may opt for the Canadian finance minister's proposal for a modest allocation as a suitable compromise. [ ]

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- o LDC Debt Issue and the Reform Agenda. France will probably mention its list of possible improvements in the monetary system aimed at helping debt-troubled LDCs. Paris will likely make the following points in addition to the SDR allocation:
    - Dependence on the dollar should be reduced by expanding the number of currencies which make up total international reserves.
    - World Bank resources, including those of the International Development Agency (IDA), should be increased and the terms on World Bank loans made softer.
    - LDC adjustment should be considered in a 5 to 7 year time frame, not the current 1 to 3 years.
- France is not seeking any new major initiatives on these points but will want a general statement in the communique that the work on the debt crisis has to continue; Paris also wants to maintain its out-in-front image concerning the needs of LDCs. [ ]

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A major attempt by the United States to block a new allocation of SDRs would draw criticism from France, Italy, and Canada, and possibly from Japan and West Germany. Such a move could also make the other summit countries less receptive to US proposals on monetary reform, such as encouraging LDCs to open up their economies to direct investment and rely less on debt to finance their economic development. [REDACTED]

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Concerns at the Summit about US fiscal policy and its implications for the multilateral surveillance process would probably be assuaged by assurances that the current efforts to reduce the US deficit will continue and that Washington supports the goal of economic convergence. The other summit countries are grappling with the problems of deficits in their own countries and realize the exercise can be a lengthy one. [REDACTED]

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#### Outlook for the Longer Term

Discussions on the current set of international monetary problems will probably go on for several years, but we believe they are unlikely to result in any fundamental changes to the system. Discussions about international liquidity have the greatest potential for major changes. Most summit countries believe the present system has a high degree of flexibility, and as a result we expect most efforts to reform the system to be aimed at fine-tuning. [REDACTED]

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We do not expect the multilateral surveillance process to change much over the next few years. The exchange of views among

[REDACTED]

the Big-5 and moral suasion are about as far as any of the major countries, except France, want to go. As the West Germans have pointed out in their G-10 reports, no country wants to give up its sovereign right to set its own economic policy, an argument that favors adhering to a flexible exchange rate regime.

Economic convergence and intervention, however, will continue to be political footballs among the major countries when exchange markets become unsettled. [REDACTED]

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We believe that the issues concerning international liquidity--the determination, denomination, and distribution of reserve assets--will remain contentious for some time to come, given the national interests at stake. The determination of SDR allocations is a cumbersome process because it requires approval of the IMF Board of Directors and critics point out even increasing the use of the SDR or the ECU does not meet the needs of all countries. Ideally a country, private firm, or individual engaged in international transactions wants to protect itself from exchange risk. Probably the best way to accomplish this is to diversify assets in the same currency mix as the denomination of liabilities. SDRs or ECUs are limited by their currency composition and do not, therefore, meet all the needs in the market. Major countries other than the US are reluctant to make their currencies more available as reserve assets and, moreover, probably do not want to face the political problems involved in legislating the change. [REDACTED]

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Proposals to change the international monetary system to develop medium-term solutions for the LDC debt crisis are likely to be few.

- o Greater complementarity. Formal joint country assessments and board meetings between the IMF and World Bank, we believe, will not be adopted. LDCs fear conditionality creeping further into Bank lending, and most of the major countries generally do not want to weaken the discipline of the IMF's programs. Nonetheless, existing IMF and World Bank programs could be made more complementary without major alterations to the institutions.
- o Protectionism. Most summit countries agree that the trade-finance links are important, but little movement on a new multilateral trade round is likely soon. While Japan, West Germany, and Canada support new trade talks, the other major countries prefer such negotiations be delayed until the economic recovery is firmly established.
- o Resources of the World Bank and IMF. Major countries, France and possibly Canada excepted, are unlikely to support new initiatives for significant changes in funding or in the Bank's current capital-to-lending ratio. Budgetary constraints among all the major countries will limit the sources of public funds for

LDCs. Also, without a larger effort on the part of LDCs to attract private direct investment, their one-sided call for more lending on softer terms will not have much resonance.

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**APPENDIX**

**International Monetary Reform: Country Briefs**

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France

**Exchange Rate Regime**      Fundamental View: Exchange rates should move gradually in response to underlying economic trends. Active intervention should be used to keep foreign exchange markets stable. [ ] 25X1

Evaluation: Flexible exchange rate system has been unstable at times and currency movements have not always reflected underlying economic trends. Major countries have not adequately coordinated their economic policies. [ ] 25X1

Recommendations: For the medium term, seeks establishment of tri-polar currency system among dollar-yen-ECU with other countries pegging to one of these or the SDR. Wants the major countries to bolster currency swap arrangements and to intervene more actively in the markets. Also wants to strengthen IMF surveillance of and cooperation with EMS countries. [ ] 25X1

**International Liquidity**      Favors a new SDR allocation. Seeks greater diversification of international reserves away from the dollar to reduce the impact of currency fluctuations. [ ] 25X1

**Institutional Reform**      Activities of IMF and World Bank group need greater complementarity--joint IMF and World Bank country assessments are needed. Believes IMF surveillance recommendations and adjustment programs should be coordinated with World Bank project and sectoral lending activity. Argues that positive effects of World Bank lending would help minimize risks of IMF short-term demand restraint measures. Seeks to extend IMF adjustment time horizon from current 1 to 3 years to 5 to 7 year period. Wants World Bank loans lengthened up to 20 years and with lower interest rates, particularly for countries willing to implement an adjustment program. Capital-to-lending ratio of Bank should be increased, as well as share of Bank's sectoral loans over project loans. Wants Bank to be the world "aid coordinator" for multilateral and bilateral aid. [ ] 25X1

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Italy

Exchange Rate Regime	<u>Fundamental View:</u> Exchange rates should move gradually according to underlying economic trends and not be a destabilizing force. [ ]	25X1
	<u>Evaluation:</u> Flexible exchange rate regime is the only viable system in turbulent economic environment. [ ]	25X1
	<u>Recommendations:</u> Major countries need to harmonize domestic policies; smaller countries need to adopt incomes policies to offset effects of exchange rate movements. [ ]	25X1 25X1
International Liquidity	Favors a new allocation of SDRs. [ ]	25X1
Institutional Reform	IMF should play more incisive role in multilateral surveillance; process should be expanded to include all G-10 countries. Multilateral discussions among countries and IMF amount to little more than an exchange of views. Multilateral surveillance process can be improved by having (1) meetings twice a year, (2) discussions based on analytical papers prepared by the IMF, (3) meetings held prior to formulation of policy in major countries, and (4) results made public in official documents. IMF needs to utilize fully instruments at its disposal: Article IV consultations, special consultations with countries, and development of a broad set of comparative economic indicators. [ ]	25X1

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